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SUBJECT: ITALY'S 2005 BANKRUPTCY REFORMS: ONE STEP CLOSER
TO CHAPTER 11

¶1. (U) Summary. Following Parmalat's financial crisis in December 2003, the Italian Parliament began the first comprehensive reform of Italian bankruptcy law since 1942. The bankruptcy reforms, first enacted as a Decree Law and later ratified by Parliament, bring Italian bankruptcy proceedings more in line with U.S. Chapter 11 proceedings. The reformed bankruptcy law seeks to preserve the integrity of the corporation through expanded use of the "concordato preventivo," ("preventive accord") under which companies facing bankruptcy can enter into debt restructuring agreements with their creditors. The reform also shortens the "claw-back" period, during which transactions entered into by the corporation can be voided, and introduces an out-of-court restructuring procedure. End summary.

Italy's 1942 Bankruptcy Law

¶2. (U) Italy's previous bankruptcy law, enacted by Royal Decree in 1942, was based on the premise of "decotus ergo fraudator" ("bankrupt and therefore a swindler") and focused on making creditors whole through liquidation of the corporate assets and dissolution of the corporate body. The 1942 law was written at a time when corporations were rare and individual traders and small partnerships, whose main asset was land, dominated the Italian economy. The law focused on liquidation of the debtor's assets because, when the main asset was land, it was the most effective way to make the lender whole.

¶3. (U) As the Italian economy developed, and corporations replaced individuals and partnerships as the main drivers of the economy, the 1942 law came under increased criticism from legal commentators for its emphasis on liquidation and cumbersome procedural rules. The shortcomings of the law are best illustrated by the following statistics:

- In 1998, out of bankruptcies valued at 5.5 billion euros, only 1 billion was actually paid to creditors. Legal and liquidators' fees totaled 250 million euros. Bank management fees totaled 750 million euros.

- Italian bankruptcy cases could last as long as six years, compared to an average of six months in Germany, seven in the U K, and eight in France.

- In 1999, creditors' claims accepted by liquidators totaled 7.5 billion euros. Of these, only 11 percent were actually paid out, leaving unpaid claims in the amount of 6.7 billion euros.

The 2005 Law

¶4. (U) Parmalat's 2003 financial crisis, in which the

company was found to have overstated its assets by eight billion euros, made clear the need to reform Italian bankruptcy law. Parmalat's bankruptcy was managed using an emergency decree by then-Industry Minister Antonio Marzano that allowed Parmalat to enter into a debt-equity swap with its creditors. The aim of the "Marzano Decree" was to preserve the company's assets through the continuation or transfer of business activity. This enabled the corporation to continue to do business, working its way out of bankruptcy, and in the process, preserved the livelihoods of many of Parmalat's 36,000 employees and the roughly 5,000 dairy farms which depended on sales to Parmalat.

¶5. (U) The most important part of the 2005 bankruptcy law reform is an extension of the "Marzano Decree" principles to smaller companies, amending an existing procedure called "concordato preventive" ("preventive accord"). The "concordato preventivo" is a judicial procedure oriented towards the reorganization of the activity of the insolvent company through an agreement between the debtor and its creditors. The new "concordato preventivo" allows smaller corporations to restructure their debt (as Parmalat did) rather than face liquidation. Unlike the 1942 bankruptcy law, the debtor is no longer required to be insolvent to be admitted to the new "concordato preventivo," provided that the debtor is in a pre-default situation, such as a temporary financial crisis. The debtor's proposal to creditors may now provide them with an assignment of assets or company shares in order to partially satisfy their claims. The "concordato preventivo" allows for the division of creditors into classes and for the restructuring of debt in almost any form, provided that the restructuring plan is approved by the creditors holding the majority of the company's unsecured debt. In fact, the secured creditors do not have the right to vote, although it seems that they must be fully satisfied by means of the debtor's restructuring plan. Expanded use of

the "concordato preventivo" should result in an increased willingness by lenders to extend credit to corporations, because there is less chance they may than face lengthy and expensive liquidation proceedings that do not result in the substantial recovery of their loans.

¶6. (U) The 2005 bankruptcy reform shortens the claw-back period of Italian bankruptcy law to a maximum of one year, down from two years under the 1942 law. The shorter claw-back period strikes a balance between the company's need to solve financial and economic problems by selling a business or activity, and the principle of guaranteeing to all creditors equal treatment in case of future bankruptcy. This reduction of the claw-back period will reduce the number of pre-bankruptcy transactions which the insolvent corporation can have voided ("clawed-back"), lowering the administrative and legal costs associated with bankruptcy. It should also make vendors more confident in extending credit to customers since "ordinary course" transactions are exempt from the law's claw-back provisions unless the corporation can prove that the creditor knew of the debtor's insolvency at the time of the transaction.

¶7. (U) The last reform introduced by the 2005 bankruptcy law is an out-of-court restructuring process. Under this provision, companies may ask the court to approve a

restructuring plan provided that the plan is agreed to by creditors holding 60 percent of the corporation's debt and has been approved by an independent expert. This procedure differs from the "concordato preventivo" (described in paragraph five) in that it does not provide for the division of creditors into classes, and requires approval by creditors holding 60 percent of all debt, as opposed to the simple majority of those holding unsecured debt required to approve a "concordato." Like the other reforms in the 2005 law, the introduction of an out-of-court settlement procedure should lower the administrative costs associated with bankruptcy. There are some ambiguities in the law, however, and experts are divided on issues such as which party is responsible for paying for the cost of the independent expert's evaluation of

the restructuring plan.

Criminal Penalties

¶8. (U) The new law retains criminal penalties for bankruptcy. If an individual's conduct has caused "actual damage" to creditors, that individual may be sentenced to six to ten years' imprisonment. This provision of the law retains the 1942 law's view of bankruptcy as an offense against the economy. Legal commentators expect these provisions to be abolished or narrowed in future revisions of the law. Mario Draghi, Governor of the Bank of Italy, has noted that the penal provisions of the new law are "based on a punitive view of bankruptcy," and has argued for their modernization.

Comment

¶9. (U) The 2005 revision of Italian bankruptcy law makes great progress in lowering the administrative, legal, and business costs of bankruptcy. It is perhaps a good sign that some judges have complained that the 2005 law diminishes judicial power in bankruptcy procedures. Even with the new law's streamlined procedures, debt recovery proceedings in Italy take five times as long as the OECD average, in large part due to the slow pace of judicial proceedings. Participants at a May 18 Rome conference on bankruptcy hosted by the Italian Banking Association generally gave the law favorable reviews, praising it for increasing the speed with which restructuring plans can be implemented and for increasing creditors' involvement in debt restructuring. Although critics of the new law are in the minority, there is a consensus that it needs fine-tuning. Bank of Italy Governor Draghi, for example, has noted that the new law only applies to half of all businesses in Italy, and has urged that its scope be broadened. Although it remains to be seen whether the new law will make financial institutions more willing to extend credit to small or start-up businesses, which are key to re-energizing the Italian economy, Italy now has a modern bankruptcy law which should increase creditors' confidence in their ability to recover their assets from a debtor facing bankruptcy.
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